No. 16702

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

[illegible] Chemical Company, a corporation, Gerald I. Farman, Hazel I. Farman, John Carver Baker and Patricia Baker,

Petitioners,

vs.

Commissioner of Internal Revenue,

Respondent.

On Petition for Review of Decision of the Tax Court of the United States.

BRIEF FOR THE PETITIONERS.

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No. 16702

IN THE

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SCHALK CHEMICAL COMPANY, a corporation, GERALD I. FARMAN, HAZEL I. FARMAN, JOHN CARVER BAKER and PATRICIA BAKER,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Review of Decisions of the Tax Court of the United States.

BRIEF FOR THE PETITIONERS.

Opinion Below.

The findings of fact and opinion of the Tax Court [R. 39-67] are reported at 32 T. C. 879.

Jurisdiction.

The petition for review [R. 70-76] involves Federal income taxes for the years 1950 and 1951. The notices of deficiency were issued and mailed by the Commissioner of Internal Revenue on May 23, 1956 [R. 6, 14, 22]. Within ninety days thereafter (specifically on August 20, 1956) taxpayers filed petitions with the Tax Court for a redetermination of the deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954 [R. 6-11, 13-19, 22-27]. The cases were consolidated for trial [R. 78]. The decisions of the Tax Court were entered on July 21, 1959 [R. 67-69]. The cases are brought to this Court by petition for review filed with the Tax Court within three months thereafter [specifically on October 19, 1959—R. 76] and served on respondent [R. 76-77]. Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954. The returns in respect of which the alleged liabilities arise were filed in 1951 and 1952 in the office of the then Collector of Internal Revenue, in Los Angeles, California [R. 75-76].

Questions Presented.

This case involves the unfortunate incident of transactions among and between a family corporation and several family members resulting in corporate expenditures the deduction of which has been disallowed and the payment of which is claimed to constitute a dividend. The questions presented are (i) whether the corporation is entitled to deduct an amount which it agreed to pay to certain family members (owning a majority interest in the Company) in reimbursement of an amount which they had paid for the benefit and protection of the Company (to rid the Company of pernicious domination by another family member having complete control of the Company by reason of a trust) and (ii) whether the reimbursement thereof and the related purchase of the shares of such other family member were distributions essentially equivalent to a dividend.

Statutes Involved.

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or business expenses.*—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . .

* * * * * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, . . .

(26 U. S. C. 1952 ed., Sec. 23.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits . . .

* * * * * * * *

(26 U. S. C. 1952 ed., Sec. 115.)[1]

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[1]As discussed hereinafter, if it be determined that no unreported dividend income was received by petitioners Baker in 1951, the other adjustments (for omitted interest income and disallowed auto expense) made by respondent are barred by Section 275(a) of the Internal Revenue Code of 1939, three years having elapsed after the filing of their return for 1951 prior to the assessment.

Statement of the Case.

Schalk Chemical Company was incorporated under laws of California in 1903. Since that time it has, and now is, engaged in the business of manufacturing and distributing a line of associated paint and home repair products [R. 96-97; Exs. 13 and 14].

For a period of twenty years, from December 29, 1930, to December 29, 1950, the outstanding stock (then 100,000 shares) of the Company was the principal asset of a spendthrift trust. The beneficiaries were of one family.

Under the terms and designations in the trust instrument entered into when the children were minors, a son (Horace O. Smith, Jr.) having only a 16⅔% beneficial interest in the trust and having little business experience succeeded in 1943 to the office of "Supervisor" of the trust, which office carried with it the extraordinary right to vote all the shares of the Company and to exercise absolute power and control over the management and policies of the Company [Ex. 1, pp. 3 *et seq.*]. In his management of the Company, Smith followed the example set by the (non-family member) Supervisor who preceded him. The other beneficiaries of the trust. Smith's mother (petitioner Hazel I. Farman, owning a 50% beneficial interest) and his two sisters (Evelyn Smith Marlow and petitioner Patricia Baker, each owning a 16⅔% beneficial interest), were given no voice or right to participate in the management of the Company, and his predecessor's policy of preservation of the status quo, nonexpansion and nondevelopment of new products was continued. As Supervisor of the trust and as director and President of the Company and through the officers and directors whom he elected and controlled,[2] Smith dominated the Company until 1948.

Commencing in 1945 controversies arose between Smith and the other members of the family concerning his management and policies in respect of the Company, and concerning in particular, among other things: Smith's failure to institute and implement any product development program; his inaction in meeting market trends and increased competition; his refusal to raise prices to offset rising labor and material costs; and his rejection of needed expansion of the Company's Chicago facilities (at which 80% of the Company's manufacturing is done) [R. 118-126, 137-148, 156-165, 241-242, 244-245, 299, 308, 353-356].

The other beneficiaries of the trust and members of the family believed that Smith's policies and management, particularly in the critical post-World War II period, were adverse to the best interests of the Company and were endangering its future.

Several proposals were made to settle the controversies by realignment of control [R. 150-151, 173, 413]. An executive committee was established in 1945 to manage the Company but was not permitted to function [R. 129-130, 148-149; Exs. 15; J, p. 271]. Smith continued to exercise his unlimited powers.

In 1947 Mrs. Marlow and Mrs. Baker filed suit to remove Smith as Supervisor of the trust [Ex. 2].

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[2]Hazel I. Farman was a "minority director" of the Company by virtue of the trust instrument. Petitioner Gerald I. Farman, whom Mrs. Farman married in 1931, was appointed a "minority director" in 1945 by Smith's sisters, pursuant to the power to designate one director reserved to them in the trust instrument [Ex. 1, p. 5].

During 1947 the Company experienced substantial operating losses [Exs. 9, 11].

A settlement was reached finally in January, 1948, pursuant to which Smith resigned as Supervisor of the trust and as director and President of the Company and caused the resignations of the directors and officers whom he controlled [Ex. 16].

Concurrently with and in consideration of Smith's execution of the agreement, the other beneficiaries paid $25,000 to Smith with funds that they borrowed [Exs. 19, 20, 21, 36]. At the termination of the trust on December 29, 1950, the Company accepted an assignment of the settlement agreement [Exs. 5, 23] and, in February, 1951, in pursuance of the assignment, reimbursed the individuals for the $25,000 which they had paid to Smith and for interest incurred thereon [Exs. 25, 26, 27]. Upon distribution of the trust estate, the Company paid $20,000 to Smith for the property distributed to him, consisting of 16,666 shares of the Company and other properties [Exs. 6, 7, 8, 24]. The trust estate was distributed in March, 1951 [Ex. 8]. The 16,666 shares acquired from Smith are held by the Company in its treasury.

The amounts so paid by the Company in 1951 were accrued on its books in 1950 and deducted on its return for that year [Ex. A]. Individual petitioners did not report the amount received by them in 1951 in reimbursement of their respective share of the $25,000 paid to Smith nor any amount in respect of the $20,000 which the Company paid to Smith.

Respondent disallowed the deductions taken by the Company in 1950 and charged the individual petitioners with dividend income in 1951 by reason of the foregoing transactions.[3] The decisions of the Tax Court sustain respondent.

Petitioner Schalk Chemical Company has conceded that it is not entitled to deduct the $20,000 paid to Smith in 1951 for his share of the trust property [R. 56].

Additional adjustments were made in the 1951 return of petitioners Baker for omitted interest income and disallowed auto expense. These adjustments were not contested in the Tax Court. However, unless petitioners Baker omitted dividend income from their 1951 return such additional adjustments are barred by Section 275(a) of the Internal Revenue Code of 1939.

Specification of Errors to Be Urged.

1. The Tax Court erred in holding that the Company was not entitled to deduct the $25,000 which it agreed to pay to Hazel I. Farman, Patricia Baker and Evelyn Marlow in reimbursement of the $25,000 previously paid by them to Smith.

2. The Tax Court erred in holding that the $25,000 was not paid to Smith on behalf of the Company and for its benefit and the preservation and protection of its business.

3. The Tax Court erred in failing to hold that the $25,000 was paid to Smith on the Company's behalf and for its benefit and the preservation and protection of its business in order to free the Company from the absolute control which Smith, a minority owner, had and exercised over the Company by virtue of the extraordinary

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[3]The 1950 deficiency assessed against the Company is $15,087.22. The 1951 deficiencies assessed against petitioners Farman and Baker are, respectively, $11,589.98 and $2,465.86.

trust powers which he possessed, in failing to hold that the majority owners had reasonable grounds for believing that removal of Smith and his management was essential to protect and preserve the Company, and in failing to hold that in similar circumstances persons of ordinary prudence would have acted in similar fashion.

4. The Tax Court erred in holding that the Company was not morally obligated to reimburse Hazel I. Farman, Patricia Baker and Evelyn Marlow for the $25,000 paid by them to Smith.

5. The Tax Court erred in holding that the Company was not entitled to deduct in 1950 as a business expense the amount which it agreed to pay to Hazel I. Farman, Patricia Baker and Evelyn Marlow to compensate them for interest incurred in borrowing the $25,000 paid to Smith.

6. The Tax Court erred in holding that the payment of $25,000 made by the Company to Hazel I. Farman, Patricia Baker and Evelyn Marlow in 1951 constituted a dividend to petitioners Hazel I. Farman and Patricia Baker in that year, to the extent that they participated in the payment.

7. The Tax Court erred in holding that the payment of $20,000 made by the Company to Smith in 1951, for his share of the trust estate, constituted a distribution essentially equivalent to a dividend to the remaining shareholders of the Company pro rata, including petitioners Hazel I. Farman and Patricia Baker.

8. The Tax Court erred in holding that the payment of $20,000 made by the Company to Smith in 1951, for his share of the trust estate, discharged a contractual obligation of the remaining shareholders.

Summary of Argument.

The tax laws permit the deduction of disbursements made to protect and preserve a business. The $25,000 was paid to remove Smith from control of the Company. By virtue of the trust his power to control the Company was absolute although he was only a one-sixth beneficial owner. In form the transaction was between Smith and the other beneficiaries. But it was the only means available to the latter to protect the Company. Smith would not relinquish control under any other arrangement, with the Company or otherwise. Because of the Company's financial condition and the detrimental effect which Smith's management was having on the Company, the other beneficiaries believed that they could not risk waiting three years until termination of the trust and the expiration of Smith's power. They paid the $25,000 to Smith in order to preserve and protect the Company and their interests therein.

Their action was in substance action which the Company would have taken but for Smith's control. The Company was morally obligated to make reimbursement for the expense and is entitled to a deduction therefor.

Neither the reimbursement nor the eventual purchase by the Company of Smith's share of the trust assets upon distribution of the trust resulted in any true economic benefit to the individual petitioners. No stock or right to stock was acquired by them from Smith. Company funds were not used to satisfy any valid obligation of the individual petitioners. The trust was a spendthrift trust and the purported agreement for the purchase and sale of Smith's future share of the trust assets upon distribution of the trust was unenforceable against the individual petitioners as a matter of law.

The individual petitioners, having paid the $25,000 to Smith for the benefit of the Company, are not chargeable with receiving a dividend by reason of reimbursement of the money. Nor are they chargeable with a constructive dividend by reason of the Company's purchase of Smith's share of the trust assets upon distribution of the trust, no obligation of theirs having been satisfied by the purchase.

The Tax Court rests its opinion on the form, rather than the substance and legal effect, of the transaction with Smith. The cases relied on by the Tax Court are distinguishable.

ARGUMENT.

I.

It Is Well Established That a Disbursement Made to Protect or Promote a Taxpayer's Business Is Deductible.

A. The Courts and the Tax Court Repeatedly Have Allowed Deductions for Disbursements of Such Nature.

In *A. King Aitkin,* 12 B. T. A. 692 (1928), two members of a partnership bought the partnership interest of a third partner whose conduct was jeopardizing the firm. They paid him $5,000 in excess of the value of his partnership interest. The $5,000 was allowed as a business expense of the partnership. (The *Aitkin* case was followed in *Charles F. Mosser,* 27 B. T. A. 513 (1933).)

In *Olympic Harbor Lumber Co.,* 30 B. T. A. 114 (1934), affirmed 79 F. 2d 394 (9 Cir. 1935), it was held that of the sum of $7,900 paid in a transaction which involved the acquisition of assets at least $5,400 was paid to get rid of an unsatisfactory contract and that not more than $2,500 was for the assets taken over. Deduction of the $5,400 was allowed.

In *Helvering v. Community Bond & Mortgage Corp.*, 74 F. 2d 727 (2 Cir. 1935), the Mortgage Company entered into an agreement with another corporation under which the latter became the exclusive selling agent for the former's securities. The arrangement became harmful and embarrassing to the former because of the methods employed by the latter. The Mortgage Company purchased all the outstanding stock of the other corporation and caused its dissolution. It was held that the $30,000 paid for the stock was deductible.

In *First National Bank of Skowhegan*, 35 B. T. A. 876 (1937), the bank paid $10,000 to an out-of-town bank in consideration of the latter's taking over the assets and assuming the liabilities of a local state bank which was about to be closed. It was held that the $10,000 was an ordinary and necessary business expense incurred for the protection of the bank's business, its depositors and its shareholders.

In *Dunn & McCarthy, Inc. v. Commissioner of Internal Revenue*, 139 F. 2d 242 (2 Cir. 1943), payments to employees in repayment of loans made by them to the company's president, who died insolvent, were held to have been made to preserve the good will of the company, and deduction was allowed.

In *Boulevard Frocks, Inc.*, T. C. Memo. Dec. (1943), amounts paid by a company to buy up the employment contracts of certain of its stockholders who were disrupting its business were held to be ordinary and necessary business expenses, to preserve, promote and protect the company's business.

In *Catholic News Publishing Co.*, 10 T. C. 73 (1948), the company's business and reputation were threatened by a controversy between its president and third parties involving a personal claim asserted against the president. The company's board of directors fearful of further injury to the company's business and reputation directed the president to settle the claim. He did so personally and was reimbursed by the company. The reimbursement was held to be an ordinary and necessary expense deductible by the company.

In *The Stuart Company,* 195 F. 2d 176 (9 Cir. 1952), the company entered into a settlement agreement under which it was obligated to pay $197,700 to another corporation. It was held that $75,000 of the $197,700 constituted a deductible obligation incurred to secure cancellation of an onerous contract and that the remaining $122,700 was allocable to the purchase of a trademark and not deductible.

In *Pressed Steel Car Co.,* 20 T. C. 198 (1953), an expenditure of $375,000 to acquire the stock of another corporation having a burdensome contract with the company was allowed as a business expense.

In *Capitol Indemnity Ins. Co. v. Commissioner of Internal Revenue,* 237 F. 2d 901 (7 Cir. 1956), the company in consideration of cancellation of an agency agreement assumed an obligation undertaken by the agent to repay purchasers of the company's "Founder's Stock" the full amount they had paid for the stock. The agency agreement made it impossible for the company to operate profitably. Payments made by the company to repurchase its "Founder's Stock" were held deductible as ordinary and necessary business expenses.

In *Alleghany Corporation,* 28 T. C. 298 (1957), costs of contesting some, and successfully proposing other, reorganization plans affecting its stock interest in a bankrupt railroad were held to have been incurred to protect the company's business, and deduction was allowed.

According to the foregoing cases, it is immaterial to deductibility that the expense involves a payment to shareholders (*Boulevard Frocks, Inc., supra; Capitol Indemnity Ins. Co. v. Commissioner of Internal Revenue, supra*), that the transaction takes the form of a purchase of assets (*Olympic Harbor Lumber Co., supra; Helvering v. Community Bond & Mortgage Corp., supra; Pressed Steel Car Co., supra; Capitol Indemnity Ins. Co. v. Commissioner of Internal Revenue, supra*), that the transaction is for the protection of an existing investment (*Dunn & McCarthy, Inc. v. Commissioner of Internal Revenue, supra; Alleghany Corporation supra;* compare *Rittenberg v. United States,* 267 F. 2d 605 (5 Cir. 1959))), or that the actual expenditure is in reimbursement of a payment made by another person on behalf of the company (*Catholic News Publishing Co., supra*).

B. The $25,000 Was Paid to Preserve and Protect the Company.

Petitioners contend that the $25,000 was paid to Smith to secure his resignation as Supervisor of the trust and as director and President of the Company and the resignation of the directors and officers whom he controlled. Assuming for the purposes of this argument, but without any concession on petitioners' part as to the substance or effect of the actual transaction, that the Company had paid $25,000 to Smith in consideration of his resignation as Supervisor, the payment would have been deductible.

For one thing, promotion of harmony in the conduct of a business is a proper corporate business purpose.

Fred F. Fischer, T. C. Memo. (Dec. 1947); *Gazette Pub. Co. v. Self,* 103 Fed. Supp. 779 (E. D. Ark. 1952). There was more here, however, than elimination of internal strife affecting the Company's operations. Competition in the Company's specialty field had multiplied many times following the end of World War II. Newer and easier to use products had come on the market. In the opinion of the other beneficiaries, the Company under Smith's management was not keeping, and was not attempting to keep, pace with competition, either in products or other matters, such as trade discounts.

The Company had eight products on the market in 1947 [R. 96]. The Company had started in 1903 with "Hydro Pura." "Savabrush" was added in 1920 and the Company's mainstay item, "Double X," was added in 1924. The remaining five were put on the market, respectively, in 1932, 1937, 1940, 1946 and 1947, the last two through the efforts of petitioner Gerald I. Farman, with Smith's reluctant blessing. These products all were in powder form, and although competitors were introducing comparable products in liquid form which were easier to use Smith refused to supplement the Schalk line with like products.

The need for new and improved products was noted during Curtis C. Colyear's tenure as Supervisor. A memorandum from H. C. Lieben to Colyear dated January 25, 1941 [Ex. J, p. 221], by way of explanation of the loss suffered by the Company in 1940, states:

> "While our other specialty items have either held their own or enjoyed an increase, Double X Floor Cleaner has been declining rapidly since ~~1947~~. This
>
> 1937

has been due primarily to increased competition of lower priced items, use of new floor finishes and increased usage of sanding machines."

"Double X" was the Company's leading article in money and sales value. It was the item with which the Company's salesmen could do the biggest volume. In 1937 sales of "Double X" totalled $104,209. By 1940 sales of this product had declined to $78,000. Sales of "Hydro Pura" had dropped to $14,363 by 1939, as compared with a peak of $270,244 in 1922.

The adverse trend in the Company's business was suspended by the war. Smith's management rode along with the false economy, with no research and development program, and with no plans for meeting problems which it was obvious would beset the Company after the war. Smith admitted that the Company should have had a research and development program [R. 373, 406].

Labor and material costs greatly increased [R. 87], but until the change in management in 1948 no price increases were instituted [R. 101-102]. In fact none had ever been made on any of the Company's products.

Operating losses were sustained monthly commencing in February 1947, cumulating to a total operating loss of $32,158.67 in 1947 [Exs. 9, 11; R. 85]. By the end of 1947 working capital was seriously depleted and a bank loan of $20,000 was due in January, 1948 [Exs. 9, 17].

These and other disturbing matters concerning the business, Colyear's management and Smith's management were testified to by petitioner Gerald I. Farman and by Earl F. Bradley, a salesman for the Company for thirty-five years [R. 118-126, 137-148, 156-165, 241-

242, 244-245, 246-254, 299, 308, 353-356], and not contradicted by Smith in any essential respect.

At the time of the settlement, three years remained to run before termination of the trust, during which Smith would have continued to dominate the Company. It is doubtful in view of the Company's financial condition at the end of 1947 whether it could have withstood another loss year, let alone three years.

Management was changed in 1948. Prices were increased [R. 101-102]. Trade discounts were made competitive [R. 103]. The Company's accounts were surveyed and new outlets were secured [R. 166-168]. Nine new competitive products were placed on the market in the period from 1948 to 1956 [R. 97].

Unless there were some real threat to the Company, it is not rational that any amount would have been paid to Smith. His domination of the Company would have ended with the termination of the trust. There was no need to anticipate this fact by a payment of money which he could not have demanded but for the extraordinary power which the trust gave him. The other beneficiaries of the trust automatically would have succeeded to control of the Company at the end of 1950.

The Tax Court, deflected by reliance on the form of the transaction, gave little heed to the surrounding circumstances:

> "We are satisfied that they [the other beneficiaries] thought their participation would be beneficial to the corporation, but we are not convinced that the management of the corporation under Smith was incompetent and that their action was either necessary or desirable to preserve its business." [R. 59.]

This is tantamount to the finding of the Tax Court reviewed in *Levitt & Sons v. Nunan,* 142 F. 2d 795 (2 Cir. 1944). In that case, demand had been made on the corporate taxpayer for an accounting in respect of certain property which it possessed. It was claimed that a shareholder of the company who also was manager of the claimant had obtained the property as the result of an abuse of trust. The claim was settled for $65,000, which was deducted on the theory that it had been paid to avoid unfavorable publicity. Disallowance of the deduction was sustained by the Tax Court on the ground that "the anticipated injury to the business was not certain to occur." The Second Circuit held this to be a wrong interpretation of the statute, stating:

> "That such payments to protect a business generally are 'ordinary' expenses is abundantly settled by authority and can no longer be questioned . . . they are altogether normal. Whether they are 'necessary' depends upon the questions on which the Tax Court did not pass, because of its misconception of the statute. . . . An expense to avoid such results [damage to credit and reputation] may be 'necessary', although the anticipated loss is not inevitable; *business, like everything else, can only be conducted upon prophecies, and prophecies are never infallible.* If in the case at bar the Levitts were right in thinking that Edelman's suit would be likely to have those effects upon its credit which they expected, that was enough; 'necessary' in this connection only means necessary, if reasonable expectation proves well grounded." (142 F. 2d at 798.)[4]

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[4]Emphasis in quoted material added throughout unless otherwise noted.

According to *C. Ludwig Bauman & Co. v. Marcelle,* 203 F. 2d 459 (2 Cir. 1953), at page 462, "good faith business judgment" is the test of "necessary."

And, as stated in *Welch v. Helvering,* 290 U. S. 111 (1933), at 115:

> "The standard [ordinary and necessary expenses] set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."

If taxpayers were to have the burden of *"convincing"* the Tax Court that an expenditure to preserve, protect or promote their business was "necessary or desirable," such expenses would never be allowed. The proper test in this instance was whether there existed reasonable grounds for believing that if a change in the management of the Company were not effected prior to termination of the trust the Company might fail or become wasted to an extent from which it could not recover. In petitioners' opinion, reasonable grounds existed for the belief that the Company was likely to suffer irreparable damage if a change in management were not effected prior to determination of the trust. Expenditure of $25,000 to secure the change in management falls within the statutory test of "ordinary and necessary."

C. The Company Was Obligated to Make the Reimbursement.

If form be disregarded—and it must be—it is evident that the $25,000 was paid for the benefit and protection of the Company and the Company became morally obligated to indemnify the other beneficiaries, not only for the $25,000 which they paid to Smith but also for the interest they incurred in borrowing the money. The Company met its obligation by the 1950 assignment agreement [Ex. 23] and the payments which it made in 1951.

It is settled law that a moral obligation is sufficient consideration for a subsequent promise. *Fraser v. San Francisco Bridge Co.,* 103 Cal. 79, 36 Pac. 1037 (1894). Moreover, deductibility of an expense is not affected by the fact that it is predicated on a moral obligation.

As stated in *Abraham Greenspon,* 8 T. C. 431 (1947):

> ". . . even if the obligation, springing as it did from a business transaction, were only a moral obligation, we do not understand that fact of itself would preclude a deduction." (8 T. C. at 434.)

In *Catholic News Publishing Co.,* 10 T. C. 73 (1948), which is discussed above in Part A, the Tax Court stated:

> "The manner of effecting settlement appears to us to be a matter of complete indifference. That is to say, the fact that Ridder [the company's president] first used his own funds to pay the association and was reimbursed by the petitioner in equal amount calls for no different result than if petitioner had made direct payment to the association or, in the first instance, had given Ridder the money to turn over to the association. And, even if there was no express understanding, petitioner was certainly obligated in equity and good conscience to reimburse Ridder, cf. *Gilt Edge Textile Corporation,* 9 T. C. 543, in view of the fact that it had directed him to settle a claim for which he denied all personal liability and which he would not otherwise have paid." (10 T. C. at 76-77.)

The Tax Court, however, found such cases to be inapplicable here because:

> ". . . Schalk did not authorize them [the other beneficiaries] to act, formally or informally, and it was not obligated, morally or legally, to reimburse them for the $25,000 they paid pursuant to the terms of the settlement agreement." [R. 59.]

II.

The Tax Court's Determination Rests on the Form, Rather Than the Substance and Legal Effect, of the Transaction With Smith.

The Company was not named as a party to the settlement agreement with Smith. The agreement was between Smith and the other beneficiaries of the trust. They, not the Company, borrowed and paid the $25,000 to Smith. The minutes of the meetings of the pre-January 15, 1948 board of directors dominated by Smith contain no authorization or direction that the other beneficiaries act on the Company's behalf in dealing with Smith. The trust agreement placed complete control of the Company in Smith.

These facts constitute the principal ground on which the Tax Court premised its opinion:

> "The parties to the settlement agreement were in fact the other beneficiaries and Smith. Schalk was not a party to, and did not authorize the other beneficiaries to enter into, the agreement. Petitioners' argument . . . is without merit. Their reasoning is that . . . their action was in substance the action of Schalk. This reasoning overlooks the fact that the trust agreement, which created their beneficial interests, placed complete control of

Schalk in Smith, the supervisor of the trust, and prevented them from acting for or on its behalf." [R. 58.]

"In any event, Schalk did not authorize them to act, formally or informally, and it was not obligated, morally or legally, to reimburse them for the $25,-000 they paid pursuant to the terms of the settlement agreement." [R. 59.]

"As already noted, Schalk was not a party to the settlement agreement, did not authorize the payment, and was not obligated, legally or morally, to reimburse them therefor. Its action in reimbursing them for the payment was, therefore, voluntary, and . . . the distribution constituted a dividend. . . ." [R. 63.]

A. Taxation Should Depend on Substance, Not Form.

In *Landa v. Commissioner of Internal Revenue,* 206 F. 2d 431 (D. C. Cir. 1953), the Tax Court rejected oral testimony offered to support the deductibility of payments to a former wife as alimony. The written agreement in question described the payments as installments of principal and interest on a note in favor of the wife. In reversing the Tax Court, the District of Columbia Circuit stated:

"Generally, '[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding.' The taxpayer as well as the Commissioner of Internal Revenue is entitled to the benefit of this rule." (206 F. 2d at 432.)

In a subsequent appeal in the same case, 211 F. 2d 46 (D. C. Cir. 1954), the District of Columbia Circuit again reversed the Tax Court, stating:

> "The purpose of this rule [quoted above] is manifest. Whenever taxation is allowed to depend upon form, rather than substance, the door is opened wide to distortions of the tax laws which, after all, represent the legislative judgment for an equitable distribution of the tax burden generally. Clearly, this purpose is not advanced by applying the rule only if it serves to increase the tax in the particular case." (211 F. 2d at 50.)

In *Jennings v. United States,* 272 F. 2d 842 (7 Cir. 1959), a corporation made payments to its majority shareholders which it charged against "contributed or paid-in surplus." Previous to the distributions, loans made to the corporation by the shareholders had been removed from a liability account and credited to the same surplus account. It was held, notwithstanding the entries, that the distributions were repayments of loans, and not dividends, because it was so intended.

B. The Form of the Settlement Was Dictated by Smith and the Other Beneficiaries Had No Choice.

As found by the Tax Court:

> "During the course of the negotiations leading to the settlement agreement, the other beneficiaries of the trust proposed that the settlement be by agreement between Smith and Schalk. Smith *rejected* their proposals that Schalk be a party to the agreement or pay any part of the money which he was demanding. He *insisted* upon dealing directly with the other beneficiaries." [R. 46-47.]

Henry D. Wackerbarth, Smith's attorney, testified:

> "Q. [Mr. Hall] Now, is it your testimony that Mr. Guthrie and Mr. Olson did not propose that the money be paid by the corporation to Mr. Smith? A. Is it my testimony that they did not propose that?
>
> Q. Yes. A. No. That is not my testimony.
>
> Q. That was their proposition? A. That was their proposition.
>
> Q. And that was over many months of this negotiation, was it not, their proposition? A. How long I can't say, but it was never accepted, if that means anything.
>
> Q. Sure. In other words, from your side of the picture, and Mr. Smith's side of the picture, you were insisting that it be between the family members? A. That is correct.
>
> Q. Is that correct? A. That is correct.
>
> Q. And on Mr. Guthrie's side, and the family's side, they were trying to work it out so that the corporation would pay the money to Smith, rather than the individuals? A. That is correct." [R. 452-453.]

The point is summed up in this excerpt from the testimony of Milo V. Olson, who assisted Stanley W. Guthrie in representing the other beneficiaries of the trust:

> "If you state settlement, Mr. Smith would only settle on the basis which was set forth in the agreement that was finally executed. . . .
>
> "As I understand, the [sic] settlement, your choice is what the other party is willing, finally willing to do. . . . The family could have continued to litigate. They did have that choice, but we chose to settle." [R. 390.]

C. The $25,000 Was Paid for Smith's Entering Into the Settlement Agreement and Relinquishing Control of the Company.

The Tax Court erroneously interpreted the settlement agreement as providing that the $25,000 was a "down payment" on the purchase price of Smith's share of the trust property at the time of termination and distribution of the trust [R. 61].

The agreement was skillfully drawn to Smith's and his attorney's specifications.

It first provides that in consideration of the sum of $25,000 then paid, Smith agrees to sell to the other parties upon termination and distribution of the trust all his right, title and interest in the corpus and any accumulations [Ex. 16, pp. 1-2]. Within 30 days after actual distribution of the trust, the other parties agree to pay to Smith $20,000 [*Ibid.* p. 2].

Then follows this language:

> "It is understood and agreed that this agreement shall not be intended or construed as an assignment or transfer by First Party [Smith] of any present right, title or interest of First Party in or to said trust . . . and that no transfer of any interest of First Party in or to said trust . . . shall be made by First Party until said trust has terminated and the corpus . . . shall have been distributed to First Party." [*Ibid.* p. 2.]

The succeeding four paragraphs include provisions for an escrow at the time of distribution of the trust (*Ibid.*, pp. 2-4).

It is then provided commencing on page four:

"In consideration of First Party agreeing to resign as supervisor of the trust hereinbefore described and as officer and director of Schalk Chemical Company, a corporation, and of his securing the resignation of Henry O. Wackerbarth as an officer, director and attorney for said corporation, and of H. T. Rausch as a director and auditor of said corporation, the parties hereto agree to enter into a stipulation for the entry of a judgment in the action in the Superior Court of the State of California in and for the County of Los Angeles, entitled Evelyn Smith Marlow and Patricia Farman Baker, as Plaintiffs, vs. Union Bank and Trust Co. of Los Angeles, a corporation, et al, as Defendants, and numbered 528,107 in said Court, which said stipulation is being entered into concurrently herewith.

"In the event that Second Parties, their heirs, successors, or assigns, shall fail, neglect or refuse to pay the balance of the purchase price as herein provided, First Party shall be released from any and all obligation to sell, transfer, convey or assign the property herein described, and Second Parties, their heirs, successors and assigns, shall be released of any and all obligations to purchase said property or to pay to First Party any additional moneys hereunder.

"The entire purchase price for the property herein agreed to be sold by First Party to Second Parties shall be the sum of $45,000.00, less any distribution made by First Party from said trust as herein provided, and the sum of $25,000.00 paid by Second

> Parties *as consideration to First Party for entering into this agreement* shall, in the event Second Parties, their heirs, successors or assigns, comply fully and promptly with the terms and conditions hereof, be applied towards said total purchase price." [*Ibid.* pp. 4-5.]

The agreement concludes with miscellaneous provisions permitting assignment by "Second Parties," providing for insurance on Smith's life in the sum of $25,000 in favor of "Second Parties" and declaring that time is of the essence and that the agreement shall inure to the benefit of the heirs, executors and assigns of the parties [*Ibid.,* pp. 5-6].

The agreement is artfully ambiguous. It was so designed to give Smith a basis for claiming payments thereunder as capital gains, and not ordinary income, which he did [R. 421].

The true transaction is set forth in Smith's written offer of September 12, 1947 [Ex. 22]. Exhibit 22 clearly identifies the $25,000 as a consideration for Smith's relinquishment of control. Exhibit 16 represents a change in form, not substance.

D. The Settlement Agreement Was Invalid as a Contract for the Purchase and Sale of Smith's Share of the Trust.

The trust involved in this case was a spendthrift trust. Article II, Paragraph (O), of the trust instrument [Ex. 1, pp. 14-15] provides:

> "The beneficiaries of the trust or any trust created hereby or hereunder, are and each of them is, restrained from and they jointly are and each is and shall be without right, power, or authority to

sell, give, transfer, pledge, mortgage, hypothecate, alienate, anticipate, discount, or in any manner to affect or impair their, his or her beneficial legal rights, titles, interests, claims or estate, in and to the income and/or principal of said trust or trusts, during the entire term thereof, or of any thereof, nor shall said rights, interests, titles, claims or estates of said beneficiaries or of any of said beneficiaries be subject or liable to the rights or claims of any creditor of said or of any of said beneficiaries, nor subject to any process of law or court, and all of the net income and/or principal of said trusts or any of them shall be transferable, payable and deliverable only, solely, exclusively and personally to the beneficiaries and each of them and their heirs at law at the time they are, or he or she is, entitled to take the same under the terms of said trust, or of any of them, and the personal receipt of each beneficiary, his or her heirs, hereunder shall be a condition precedent to the payment or delivery of the same by said trustee to said beneficiaries and to each of them.

"Provided, however, if any of such beneficiaries has not attained his or her majority then payment to the guardian of the estate of such beneficiary shall be deemed a payment to the beneficiary and receipt of such guardian be a complete discharge of said trustee."

The trust was created in California. California recognizes spendthrift trusts.

In *McColgan v. Walter Magee, Inc.*, 172 Cal. 182, 155 Pac. 955 (1916), the California Supreme Court stated:

> "The general doctrine that spendthrift trusts, inalienable by the beneficiary and inaccessible to his creditors during his life or for a term of years, are valid in this state, is well established." (172 Cal. at 186.)

A beneficiary of a spendthrift trust may not dispose of his interest in the corpus. *Kelly v. Kelly,* 11 Cal. 2d 356, 79 P. 2d 1059 (1938); *Estate of Madison,* 26 Cal. 2d 453, 159 P. 2d 630 (1945).

As stated in *Kelly v. Kelly, supra*:

> "It is of the essence of a spendthrift trust that it is not subject to voluntary alienation by the *cestui* . . . But it is everywhere agreed that after the beneficiary has actually received the trust property . . . he may dispose of it as he wishes." (11 Cal. 2d at 362.)

California, however, recognizes that the beneficiary of a spendthrift trust may contract to assign the trust property when and if received by him. But such an assignment gives the assignee no right in specific trust property received by the beneficiary.

The rule is declared in *Kelly v. Kelly, supra:*

> "But although it cannot be held that the beneficiary, upon receipt of trust property, in turn holds said specific property, or its proceeds, in trust for his assignee under an assignment made prior to his receipt of the trust property . . . we are of the view that an assignment by the beneficiary, in the nature of a promise to pay or turn over trust prop-

erty when received by him, is *not* wholly invalid. Although such an assignment or promise gives the promisee *no right in specific trust property received by the beneficiary, or in its proceeds,* such promisee has available to him the usual remedies for breach of contract and may sue to recover damages for breach of said contract, in which the damages will ordinarily be the value of the property the promisee would have received had the beneficiary performed his promise to turn over a fraction of the trust property upon its receipt." (11 Cal. 2d at 363-364.)

The California rule was recognized in *Century Indemnity Co. v. Woodruff,* 119 Fed. Supp. 581 (N. D. Cal. 1954), although in that case an assignment of an interest in a spendthrift trust was held totally unenforceable under applicable Illinois law.

In so far as the settlement agreement pertained to Smith's trust interest, it was ineffectual except as a contract to assign.

The other beneficiaries of the trust, therefore, were not obligated to purchase the property distributed to Smith upon termination of the trust but had a possibility, if they or their assigns desired to do so, of acquiring such property, provided Smith survived termination of the trust and chose to comply with his promise. Such contingent right was less than an option, since the right could not be specifically enforced. No capital asset or right to a capital asset was acquired by virtue of the settlement agreement [Ex. 16] or the assignment agreement [Ex. 23].

III.

No Unreported Dividend Income Was Realized by the Individual Petitioners in 1951.

The circumstances surrounding the settlement with Smith compel the conclusion that the other beneficiaries intended to act to protect and preserve the Company and believed that a change in management was imperative for the reasons discussed above in Part I. The Tax Court was "satisfied" that the other beneficiaries "thought" a change in management and policies would be beneficial to the Company [R. 46, 57, 59].

The personal benefits stressed by the Tax Court [R. 59] which might accrue to the other beneficiaries as income beneficiaries of the trust and later as shareholders, if the anticipated betterment of the Company materialized, are beside the point. The other beneficiaries believed that Smith's management was endangering the ability for the Company to continue as a going concern. To wait for termination of the trust and automatic cessation of Smith's control might have been fatal. Since Smith was unwilling to do anything tangible to remedy the apparent deficiencies in his management, the only recourse of the other beneficiaries was to induce Smith to relinquish control in advance of termination of the trust. The litigation had not progressed beyond the demurrer stage and might have become moot by reason of termination of the trust prior to final determination.

The other beneficiaries realized no gain or loss from the transaction with Smith and reimbursement by the Company. They had to borrow the $25,000 which was paid to Smith [R. 186; Exs. 19, 20, 21, 36]. They had no desire or reason to want to acquire Smith's one-sixth interest in the corpus of the trust [R. 174, 330]. The objective was to relieve the Company of domination by Smith. Smith, for personal reasons, coupled his agreement to relinquish control of the Company with a purported agreement for the purchase and sale of the trust property due him upon termination and distribution of the trust.

In the language of the Eighth Circuit in *Tucker v. Commissioner of Internal Revenue,* 226 F. 2d 117 (8 Cir. 1955), at page 179:

> "This is not a case where one in control of a corporation has, under the pretense of corporation action, siphoned off its profits for purely personal purposes."

The $25,000 "blood money" [R. 183] which Smith demanded was paid by the other beneficiaries as a temporary expedient, with the expectation that when able to do so the Company would repay them [R. 185-187, 331]. By the end of 1950, the Company was able to make the repayment.

Observing the substance, and not the form, of the transaction, the Company in reality paid the $25,000 to Smith for a proper corporate business purpose with funds borrowed by the other beneficiaries and loaned to the Company.

Analogous circumstances existed in *Fox v. Harrison,* 145 F. 2d 521 (7 Cir. 1944). The president of a corporation, owning two-thirds of its stock, was heavily indebted to the corporation. He sought to liquidate his indebtedness by surrender and retirement of a portion of his stock. When advised that this could not legally be done, he threatened to liquidate the corporation, unless his stock were purchased at par. The corporation was not financially able to purchase the stock. Fox, owning the remaining one-third of the stock, unsuccessfully endeavored to borrow money for the corporation. He then borrowed money on his own credit and purchased the stock interest of the president. When it was able to in a subsequent year the corporation purchased the stock which Fox had thus acquired, at the price he had paid for it. In holding that the distribution was not essentially equivalent to a dividend, the Seventh Circuit stated:

> ". . . [The Government's] theory is apparently predicated upon the mere form of the transaction, without giving consideration to the substance. In reality, the involved stock was purchased by the corporation from Cross. That the purchase was not made directly from him was due to the inability of the corporation readily to finance such purchase. Appellee merely supplied the security by which the finances were obtained. The very checks which he received for the stock when it was turned over to the corporation were used in payment of the loan which he had obtained from the bank. He realized no gain or profit on the transaction. His relation to the transaction is very aptly described by the District Court:
>
> '* * * that Fox was acquiring said stock on behalf of the corporation and as a temporary expedient, and that when the corporation should accumulate a sufficient surplus and should have available funds, it would take the stock off of Fox's hands. He had no desire or purpose to make a permanent, personal investment in the Cross stock.' " (145 F. 2d at 522-523.)

Certainly the other beneficiaries received no dividend income by reason of the Company's payment of $20,000 to Smith in 1951 for his share of the trust property. As discussed above in Point II, Part D, the settlement agreement was invalid and unenforceable except as a contract on Smith's part "to assign" his share of the trust property upon termination of the trust, for the breach of which he might have been held for damages. *Kelley v. Kelly,* 11 Cal. 2d 356, 79 P. 2d 1059 (1938). No right to such future property was acquired. All that the other beneficiaries and the Company acquired by reason of the settlement agreement and its assignment to the Company was the possible right, if desired, to purchase Smith's share of the trust property, if he survived termination of the trust and chose to honor the agreement. Such contingent right was less than an option, since it was not specifically enforceable.

The assumption and exercise of such right by the Company did not result in dividend income to the individual petitioners. *Holsey v. Commissioner of Internal Revenue,* 258 F. 2d 865 (3 Cir. 1958), so holds. Holsey owned 50% of the stock of a corporation and held an option to purchase the other 50%. He assigned the option to the corporation. The corporation exercised the option and purchased the stock at the option price. The Third Circuit held that distribution was not taxable to Holsey as a dividend.

The Internal Revenue Service has announced that it will follow the *Holsey* decision (Technical Information Release 109 (1958); Rev. Rul. 58-614, 1958-2 CB 920).

Rev. Rul. 58-614 states:

> "In the future, the Service will not treat the purchase by a corporation of one shareholder's stock as

> a dividend to the remaining shareholders merely because their percentage interests in the corporation are increased."

Note also should be taken of the following cases and rulings:

In *Ray Edenfield,* 19 T. C. 13 (1952), the taxpayer and his associates purchased part of the shares of a corporation and, concurrently, it was arranged to have the remaining outstanding shares redeemed by the corporation. The payments made in redemption of the stock were held not to constitute dividends to the taxpayer. The Internal Revenue Service has acquiesced in this decision (1953-1 CB 4). (Compare Rev. Rul. 54-458, 1954-2 CB 167.)

In *John A. Decker,* 32 T. C. 331 (1959), five individuals owning all of the stock of a corporation entered into an agreement that upon the death of any of them, the survivors would buy his stock at book value. One stockholder died in 1953, another in 1954. The survivors purchased the stock of each decedent and immediately transferred the stock to the corporation for the same price. In holding that the distribution was not essentially equivalent to a dividend, the Tax Court stated:

> "*Petitioners did not receive any true economic benefit from the transactions when considered as a whole.* They had the same amount of cash and the same number of shares of stock after the transactions were completed as they had before the death of the deceased stockholder. Their stock represented a higher percentage of equity in the basic assets of the company, but those basic assets were reduced proportionately so the stock actually represented the

same value, assuming that the book value for which the stock was bought and sold represented the value of the underlying assets. So petitioners gained nothing from the distribution unless it is that the use of company funds to meet their obligations under the stock purchase agreement produced an economic benefit for them.

"Respondent relies principally on this argument that corporate funds were used to satisfy the personal obligations of petitioners under the stock purchase agreements and, therefore, the payments were essentially equivalent to dividends, citing Wall v. United States (C. A. 4), 164 F. 2d 462 [36 AFTR 423], and Ferro v. Commissioner, (C. A. 3) 242 F. 2d 838 [50 AFTR 2084], affirming T. C. Memo 1956-94. In both of these cases, the taxpayer was the sole stockholder and had become so by previously incurring the obligation which corporate funds were used to satisfy. There was no corporate business purpose for the corporation to pay these obligations and the only ones benefiting therefrom were the stockholders, and the decision for the corporation to pay the obligation was made several years after the obligations were incurred by the taxpayers.

"In our case, *none of the petitioners ever had complete ownership or control of the corporation,* and we believe there was a sound business reason for the corporation to acquire the stock. While petitioners may have been obligated to purchase the stock of a deceased stockholder, this is a different sort of obligation from those in the Wall, Ferro, and other cases wherein this point has been raised. . . . *The corporation did not pay a pre-existing* *debt of the petitioners, the saisfaction of which would increase their net worths. They realized no economic benefit from the transaction."*

In Rev. Rul. 59-286, IRB 1959-36, p. 9, advice was requested whether a stock redemption by a corporation from an estate, the stock having originally been held equally by two brothers, constituted a constructive dividend to the remaining shareholder. The brothers, *B* and *C*, had agreed that upon the death of one of them the survivor would either purchase the decedent's stock or vote his stock for liquidation of the corporation. Upon the death of *C*, the corporation redeemed the shares held by his estate. The ruling states:

> "Under the terms of the stockholder's agreement, *B* was personally obligated either to purchase *C*'s stock or to vote his stock for liquidation of the corporation. The corporate action in redeeming *C*'s stock relieved him of his personal obligation under the agreement. However, at no time did *B* purchase the redeemed shares or obligate himself to do so; consequently the instant case is distinguishable from the case of *Wall v. United States*. . . .
>
> * * * * * * *
>
> ". . . there is no authority *affirmatively* supporting the proposition that a redemption of one stockholder's shares, at fair market value, constitutes a dividend to a remaining shareholder. . . .
>
> "In the instant case, *B* neither before nor after the redemption can be considered to have possessed the shares of stock redeemed from *C*'s estate. Accordingly, it is held that a redemption by the cor-

> poration of the decedent shareholder's shares of the corporation's stock from his estate does not constitute a constructive dividend to the remaining shareholder."

In *Fred F. Fischer,* T. C. Memo. Dec. (1947), the daughter of a deceased officer and stockholder of the Fischer Meat Company to whom stock had been willed held the conviction that the corporation was "not being successfully handled by the present management, and that . . . the expenses and the salaries have been out of proportion. . . ." She threatened to institute receivership proceedings against the corporation and to file suit contesting the deceased's Will and the validity of the trust provided for therein. Petitioner was the son of the deceased and entered into a settlement with his sister under which he agreed to purchase or secure a third party to purchase the sister's stock. Petitioner at the time was director and managing officer of the corporation. The corporation had only two directors. Petitioner and the other director held a meeting and authorized the corporation to purchase the sister's stock for an amount in excess of the fair market value of the stock. The excess was treated by the Commissioner as a payment for the benefit of the remaining stockholders, including petitioner, and taxable to them as a dividend. The Tax Court held for the taxpayer, stating:

> "On this record we cannot agree that the meat company in purchasing Mrs. Rhodes' stock was satisfying a purely personal obligation of the petitioner or the other stockholders and serving no purpose of its own. The undisputed evidence shows that several matters were in controversy. Mrs. Rhodes personally and through her counsel was complaining

of the management and operation of the business of the meat company, of its meager earnings and failure to pay dividends, whereas in the past it had been a great money maker. She threatened to institute receivership proceedings against the company, and she was demanding $275 a share for her stock at a time when the book value was only about $155 a share.

*　　*　　*　　*　　*　　*　　*

". . . the evidence of record here refutes the respondent's contention that a will contest was the only or even the primary matter sought to be settled in the compromise agreement. Furthermore, there is no foundation for an assumption that a corporation would never, in its own interests, pay more than the fair market value of its stock in order to rid itself of a complaining minority stockholder threatening to institute receivership proceedings against it. . . . *If any advantage can be said to have accrued to petitioner from the corporation's purchase of Mrs. Rhodes' stock, we do not think it is of a kind which would justify a holding that any part of the purchase price amounted to a constructive dividend to him.*"

The Tax Court relies [R. 66] on *Wall v. United States,* 164 F. 2d 462 (4 Cir. 1947), *Zipp v. Commissioner of Internal Revenue,* 259 F. 2d 119 (6 Cir. 1958), and *Garden State Developers, Inc.,* 30 T. C. 135 (1958), each of which is distinguishable.

In the *Wall* case, 60 shares of Rosedale Dairy Company were owned by Wall. The remaining 60 shares were owned by Moses. Moses died in 1933. Coleman, principal owner of Rosedale's chief competitor, purchased Moses' stock. After several years Wall initiated negotiations which culminated in an agreement dated August 28, 1937 under which Wall agreed to buy, and Coleman agreed to sell, Coleman's stock and certain other properties for \$71,700, payable \$6,700 down, \$5,000 annually for nine years and \$20,000 in the tenth year. The other properties were valued at \$14,700. Wall executed 13 promissory notes each for \$5,000. The stock was transferred to Wall and placed in a trust to secure payment of the notes.

Wall paid the down payment and the first note when it became due in 1938. In 1939 Wall entered into an agreement with Rosedale under which Rosedale agreed to pay the remaining notes (aggregating \$60,000) in return for Wall's interest in the stock purchased from Coleman which remained in trust.

In 1939 Rosedale paid the second note. This \$5,000 payment was held to constitute a taxable dividend to Wall.

The facts distinguishing the *Wall* case from the instant case are:

(i) Rosedale assumed obligations of Wall totalling \$60,000, whereas the purchase price of the stock was \$57,000;

(ii) The Coleman stock had been transferred to Wall, and "Wall owned or controlled 100 per cent of Rosedale prior to his transfer of his equity in the stock to Rosedale, and he continued to own or control 100 per cent of Rosedale's outstanding stock after the transfer." (164 F. 2d at 465);

(iii) Wall *"deliberately elected* to attain his objective by two distinct transactions. . . ." (164 F. 2d at 466);

(iv) "Wall was not acting on behalf of Rosedale but was induced by personal considerations to purchase the Coleman stock on his account. . . . There was no pressure upon the corporation to buy the Coleman stock in 1937 and no lack of corporate funds with which to make the purchase if it had been deemed desirable." (164 F. 2d at 466); and

(v) "The controlling fact in this situation was that Wall was under an obligation to pay Coleman $5,000 in the tax year and that Rosedale paid this indebtedness for Wall out of its surplus." (164 F. 2d at 464.)

In the *Zipp* case (259 F. 2d 119), all the outstanding stock (50 shares) of the corporation was owned by Zipp and his two sons. Each of the sons owned one share. In 1947 the father transferred 23 shares into the name of each son to place the shares beyond the reach of a new wife. These shares were endorsed in blank by the sons and held by the father. In 1950 the corporation paid the father $93,782.50 in money and property, in consideration of his retirement from participation in the corporation's affairs. The two shares then standing in his name were endorsed by him in blank and surrendered to the company, and he executed a disclaimer of any interest in the 46 shares transferred to the sons in 1947. The Tax Court held that (i) the father did not make a gift of the 46 shares in 1947, (ii) the transaction in 1950 was in effect the redemption of 48 shares owned by the father and (iii) the net effect of the 1950 transaction was that corporate funds were used for the benefit of the sons to purchase 48 shares from the father with the result that the sons were deemed to have received constructive dividends in the amount of the money and property paid to the father.

In contrast to the instant case in which no stock or right to stock was acquired by the other beneficiaries by virtue of the settlement agreement, the sons in the *Zipp* case acquired 46 shares, or 92% of the stock then outstanding, and ended up with a 100% ownership. As pointed out by this Court in *Niederkrome v. Commissioner of Internal Revenue,* 266 F. 2d 238 (9 Cir. 1958):

> "The Zipp holding has been severely criticized. And it has been said that, if there had been no sale to stockholders, a dividend determination could have been avoided by the remaining stockholders." (266 F. 2d at 243.)

(Compare the quotation from Rev. Rul. 58-614, *supra*).

It is true that the *Wall* and *Zipp* decisions are premised to a considerable extent, if not entirely, on the form of transactions which were involved. In each case, however, the taxpayer had a choice with respect to the manner in which the transaction was handled. In such circumstances, the applicable rule, as stated in *Woodruff v. Commissioner of Internal Revenue,* 131 F. 2d 429 (5 Cir. 1942), is:

> ". . . if a taxpayer *has* two legal methods by which he may attain a desired result, the method pursued is determinative for tax purposes without regard to the fact that different tax results would have attached if the alternative procedure had been followed." (131 F. 2d at 430.)

As discussed above in Point II, Part B, the other beneficiaries had no choice. Smith dictated the form of settlement and in so doing exacted what was the most advantageous to him personally.

In the *Garden State* case (30 T. C. 135), a corporation paid off obligations of its stockholders incurred in the purchase of its outstanding stock. The payments were charged as costs of certain land acquired by the corporation pursuant to a corporate contract existing prior to acquisition of the stock by the stockholders. The stockholders were primarily interested in acquiring the land, but the consent of the sellers of the land to an assignment of the corporate contract could not be obtained. They bought the stock of the corporation instead. The Tax Court held that the distinction between the corporation and its individual stockholders could not be disregarded because it was essential to the intended acquisition of the land.

The converse is true here. Acquisition of Smith's interest in the trust was not essential to the intended change of management. Smith's resignation as Supervisor of the trust was all that was necessary. The "agreement of purchase" was imposed by Smith. The other beneficiaries had no desire to purchase Smith's one-sixth beneficial interest in the trust.

Conclusion.

The decision in the Company's case should be reversed and the case remanded. The decisions in the individual petitioners' cases should be reversed.

June 10, 1960.

Respectfully submitted,

DONALD KEITH HALL,

Attorney for Petitioners.

APPENDIX.

Petitioners' Exhibit No.	Description	Identified	Offered	Received
1	Declaration of Trust	79	79	79
2	Pleadings, etc. Los Angeles Superior Court action	79	79	79
3	Stipulations, Los Angeles Superior Court action	79	79	79
4	Releases	79	79	79
5	Minutes of December 15, 1950, Board of Directors meeting	79	79	79
6	1951 Escrow Instructions	—	79	79
7	1951 Petition for Final Distribution of Trust Estate	—	80	80
8	1951 Order for Final Distribution	—	80	80
9	1947 Audit Report (Schalk)	82	82	82
10	Summary of Gross Sales and Net Profit or Loss (Before Taxes) 1937-1947 (Schalk)	82	83	83
11	Summary of Monthly Net Profit or Loss 1947 (Schalk)	83	85	85
12	Summary of Inventory and Purchases of Materials 1942-1947 (Schalk)	85	86	87
13	1947 Dealer's Price List (Schalk)	97	99	99
14	1958 Dealer's Price List (Schalk)	99	100	100
15	1945 Letter from Wackerbarth to Guthrie	128	128	129
16	1948 Settlement Agreement	153	154	154

Petitioners' Exhibit No.	Description	Identified	Offered	Received
17	1947 Schalk Note to Union Bank	157	158	158
18	Consent to Cancellation of Dividend	171	171	171
19	1948 Farman Note to Flora Farman	181	182	182
20	1948 Farman Note to Theodore Garbutt	182	183	183
21	1948 Farman Note to Stanley Guthrie	183	183	183
22	1947 Letter from Smith to Guthrie, Darling & Shattuck	184	184	184
23	1950 Assignment Agreement	189	189	189
24	1951 Schalk Check to Union Bank	190	190	190
25	1951 Schalk Check to Marlow	190	190	190
26	1951 Schalk Check to Baker	191	191	191
27	1951 Schalk Check to Farman	191	191	191
28	Farman Efficiency Record	290	291	291
29	(Withdrawn)			
30	1947 Letter from Dillon to Guthrie	295	295	295
31	Report of Accomplishments, WPA Operations Division, Southern California	297	298	298
32	Minutes of Executive Committee (Schalk)	311	314	314
33	Memorandum of 1945 Sales Meeting (Schalk)	316	317	317
34	Amended Inventory, Estate of Horace O. Smith	318	319	319
35	(Withdrawn)			
36	1948 Baker Note to Dr. Baker	329	329	329
37	1947 Memorandum Concerning Settlement	385	388	388

Respondent's Exhibit No.	Description	Identified	Offered	Received
A	1950 Federal Income Tax Return (Schalk)	79	79	79
B	1951 Federal Income Tax Return (Farman)	79	79	79
C	1951 Federal Income Tax Return (Baker)	79	79	79
D	1942 Audit Report (Schalk)	92	92	92
E	1943 Audit Report (Schalk)	92	92	92
F	1944 Audit Report (Schalk)	92	92	92
G	1945 Audit Report (Schalk)	92	92	92
H	1946 Audit Report (Schalk)	92	92	92
I	1951 Government Pay Schedules	210	213	213
J	Schalk Minute Book, Vol. 4	254	255	255
K	Schalk Minute Book, Vol. 5	269	277	277

The parties have stipulated that the foregoing exhibits may be considered in their original form as part of the record herein [R. 466].